Summary of the 14th Annual Bank Research Conference

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Keynote Address

Ohio State University Economist Rene Stultz discussed the nature of risk management in banks. He argued that risk can be good. If a project has a positive net present value, taking on extra risk associated with the project can be beneficial. If a bank's shareholders target risky yet beneficial projects for investment, the bank will have a high appetite for risk even if it is well governed. Thus, effective risk management should not necessarily attempt to eliminate risks, but should instead achieve an optimal level of risk that fits the institution's goals. Stultz discussed the organizational hurdles that come with implementing a good risk-management strategy and the diverse incentives of interested parties, including regulators, bank management, traders, and investors. In light of the complexity of the problem, he pointed out that mechanical limits, e.g., single-trade limits, have several shortcomings. Finally, he highlighted the importance of risk governance, incentives, and culture in achieving optimal levels of risk.

1. Liquidity and Credit Risk Management During and After the Crisis

The first two papers of the first session focused on asset liquidity. During the 2007–2008 financial crisis, many banks faced the problem of meeting liquid obligations while holding largely illiquid assets. The risk posed by this mismatch is called liquidity risk. The first paper [1A] implements a previously developed measure of liquidity risk—the Liquidity Mismatch Index (LMI). The authors demonstrate the effectiveness of the LMI as an indicator of both economywide liquidity risk and liquidity differences between banks. The second paper [1B] looks at liquidity risk and commercial loans. The authors find that during the financial crisis, banks that were more exposed to liquidity shocks were more likely to sell shares of their commercial loans. The authors argue that it is likely that these loans were sold to hedge against liquidity risk. The third paper [1C], which focuses on credit risk, shows that nonbank lenders lend to riskier borrowers when monetary policy loosens. This suggests that looser monetary policy may indeed increase the amount of credit risk taken on by lenders.

2. Intermediation and the Real Economy

The second session examined the relationship between the banking industry and the real economy. The first paper [2A] attempts to quantify the effects of the Troubled Asset Relief Program (TARP) on regional economies. The authors estimate the relationship between the quantity of TARP funds received by banks within a state and economic conditions in the state. They find that bank receipt of TARP funds is associated with improved local economic conditions. The second paper [2B] examines bank loan portfolios and local economic conditions. The authors find that changes in several bank loan portfolio performance indicators are associated with changes in key state economic indicators. They conclude that the information in bank loan portfolios may be useful for predicting local economic conditions. The third paper [2C] attempts

to determine whether there are advantages to offering a larger variety of services (having greater scope) in banking. The authors find that banks that have a larger scope are able to lend to riskier firms than banks that have a smaller scope. They also find that firms that received loans from larger-scope banks were more productive than firms that received loans from smaller-scope banks.

3. Systemic Risk: Sources of Vulnerability

The third session of the conference studied the effect of financial institutions on macroeconomic volatility. The first paper [3A] investigates the extent to which Central Clearing Counterparties (CCPs) were affected by systemic risk during the 2008–2012 sovereign debt crisis in the Eurozone. CCPs are financial intermediaries that stand between two sides of a trade and guarantee the transactions promised by each trader. Though this eliminates counterparty default risk, both sides of a trade still face the risk that the CCP itself fails. The paper finds that CCPs were largely able to insulate their users (traders) from fluctuations in Eurozone sovereign bond risk. At the peak of the Eurozone crisis, however, the CCP was ineffective at protecting traders from sovereign bond default risk. The second paper [3B] studies the way systemic risk changes with the regulatory environment of a country. The authors measure the exposure of a country's banking sector to global systemic risk. They then show that for a national banking sector, higher banking industry concentration, lower average Tier 1 capital ratios, and higher deposit insurance contributions are associated with greater exposure to global systemic risk.

4. Common Shocks and Bond Markets

The fourth session focused on the bond market and corporate defaults. The first paper [4A] investigates whether the existence of credit default swaps (CDSs) on a set of bonds can affect the market for the bonds. A CDS is a derivative wherein the issuer of the CDS insures the holder of the CDS against the default of an underlying bond. A CDS contract is called naked if the holder of the contract does not also hold the underlying debt. The author finds that a temporary ban on the trading of naked CDS contracts increases bond market liquidity, but a permanent ban decreases bond market liquidity. The second paper [4B] studies the sources of corporate default clustering—the tendency of corporate defaults to occur in groups. The authors study three channels of corporate default clustering: exposure to common macroeconomic risk factors, contagion (where the default of one firm directly affects the likelihood of default among other firms), and frailty (unobserved common risk factors). They find that accounting for all three channels is important for predicting correlated defaults.

5. Credit Ratings in Lending and Regulation

The fifth session focused on the relationship between credit ratings and lending behavior. The first paper [5A] studies the effect of credit ratings on bank lending behavior. Using Italian data, the paper estimates that during an expansionary phase of the credit cycle (2004–2007), banks did not vary the amount lent to firms in response to firms' credit ratings. Meanwhile, banks did adjust the price of credit in response to firms' credit ratings, charging up to 10 percent higher interest rates to lower-rated firms. In contrast, during a contractionary phase (2008–2009), banks did not engage in ratings-based price discrimination. Banks did discriminate through loan size, however, offering lower-rated firms up to 60 percent less credit than was offered to higher-rated

firms. The second paper [5B] looks at regulation in the insurance industry. Recently, insurance regulators have moved away from using credit ratings to assess the riskiness of assets held by insurance companies. The paper shows that foregoing the use of credit ratings in risk assessment may reduce insurance companies' tendency to sell an asset in bulk when it is downgraded. This may reduce the severity of fire-sale losses that often contribute to financial crises. The paper also argues that shifting away from credit ratings may provide insurance companies with the incentive to purchase more low-rated securities.

6. International Perspectives on Capital Requirements

The sixth session focused on the effect of capital requirements on lending behavior and exports. The first paper [6A] evaluates the impact of a 2010 policy change in Brazil that increased capital requirements in the auto-loan sector. The paper finds that banks responded to the increase in capital requirements by raising interest rates on auto loans affected by the policy. The second paper [6B] examines the effect of counter-cyclical capital buffers (CCBs) of Basel III on mortgage pricing in Switzerland. This paper has three main findings. First, in response to the introduction of CCBs, banks with low capital buffers and banks that specialize in mortgage lending raised their mortgage prices more than other banks. Second, while banks charge higher rates on riskier mortgages, such risk-based price differences do not amplify the effects of CCBs. Third, following the introduction of CCBs, both banks and insurers (who compete with banks) increased their average mortgage interest rates. The third paper [6C] evaluates the impact of Basel II on exports from Turkey. The paper finds that the adoption of Basel II significantly decreased the amount of exports financed with commercial letters of credit. However, the overall impact of Basel II on exports from Turkey was small.

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https://www.fdic.gov/bank/analytical/cfr/14th_agenda.html

References

Note: Some papers are not yet available on the Center for Financial Research website. If you would like a copy of a paper that is not available, please contact Rosalind Bennett at rbennett@fdic.gov or 202-898-7160.

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[6C] Banu Demir, Bilkent, Tomasz Michalski, and Evren Örs, “Risk-Based Capital Requirements for Banks and International Trade: Evidence from Basel II Implementation in Turkey.” Draft dated September 2014.